



**UNIVERSITI PUTRA MALAYSIA**

**THE EARNING MANAGEMENT VALUATION: EFFECTS OF  
TAX INCENTIVES ON HOTEL SECTOR IN MALAYSIA**

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**By**

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**Thesis Submitted in Fulfilment of the Requirements for the  
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in fulfilment of the requirement for the degree of Master of Science.

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**May 2000**

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This study examines the implication of optimizing earning management from tax incentives granted by the government to the hotel sector in Malaysia. Visit Malaysia Year, 1990 saw Pioneer Status and Investment Tax Allowance being introduced to the Hotel Sector, which qualifies as a promoted product or promoted activity in promoting tourism in the country.

These changes in earnings are investigated by decomposing earnings and by isolating the tax change component resulting from the actual and expected tax expenses. Earnings and the tax component are regressed with security returns. In line with this, using event methodology, the immediate effect of the announcement is observed for any abnormal gains.

Results show that there is significant correlation between the effective tax change and the security returns. In addition there is a short term monetary effect due to the announcement. However the market anticipates the information well before the official announcement with positive abnormal returns prior and on the announcement day.

Abstrak tesis yang dikemukakan kepada Senat Universiti Putra Malaysia  
sebagai memenuhi keperluan untuk Ijazah Master Sains

**PENILAIAN PENGURUSAN DANA : KESAN INSENTIF  
PENCUKAIAN BAGI SEKTOR PERHOTELAN DI MALAYSIA**

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Kajian ini mengkaji implikasi mengoptimunkan pengurusan dana kesan dari insentif sistem pencukaian ke atas Sektor Perhotelan di Malaysia. Tahun 1990, merupakan Tahun Melawat Malaysia, di mana Status Perintis dan Elaun Pencukaian Pelaburan di bawah klasifikasi promosi diperkenalkan bagi penggalakkan perlancungan di negara ini.

Perubahan dana ini diteliti melalui penghuraian dana dan memberi pengasingan perubahan belanja pencukaian akibat perbezaan perbelanjaan sebenar dengan perbelanjaan dijangka. Hasil dana dan perubahan belanja pencukaian diregresikan dengan harga pasaran saham. Selari dengan ini, dengan pengkaedaan “event” kajian ini juga mengenalpasti kesan serta merta yang diperolehi dari pulangan luar biasa.

Keputusan menunjukkan wujudnya korelasi yang signifikan antara perubahan belanja pencukaian sebenar dengan perubahan harga pasaran sekuriti. Di samping itu wujud kesan kewangan jangka pendek minimum yang disebabkan oleh pengumuman insentif pencukaian. Pelabur pasaran dapat menginterpretasikan informasi sebelum sesuatu pengumuman dengan pulangan luar jangka yang positif sebelum dan pada hari pengumuman.

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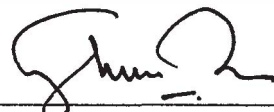
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I hereby declare that the thesis is based on my original work except for quotations and citations which have been duly acknowledged. I also declare that it has not been previously or concurrently submitted for any other degree at UPM or other institutions.

  
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Date : 24 MAY 2000

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# **CHAPTER 1**

## **INTRODUCTION**

### **Introduction**

Tax law changes would alter existing contracting environment of a firm and compel firms to modify its future contracts in order to maximize ones earnings. The ability to either renegotiate or sustain the effects of tax law changes can be viewed as one element of a firm's efficiency.

Prior research done in the area of corporate taxation failed to address the relevance of the expected ability of firms to manage earnings shocks induced by changes in the effective tax rates. This study would typically address earnings management as a response to changes in corporate tax laws.

Guenther (1994) has shown that firms managed accruals in response to the U.S. tax law changes of 1986. The study is carried out by isolating the tax component from earnings component and testing whether the relevance of this component differs among firms in the same sector.

The value of a firm experiencing a change in its effective tax rate depends, upon the expected magnitude and persistence of that change.

On a general note, firms would structure their contracts in line with the persistence of a positive tax shock (tax decrease) are valued higher than firms whose contracting failed to facilitate that persistence.

It is unlikely that the earnings impact of tax law changes is ever viewed as permanent. It is just as unlikely that a specific change in tax law affects the effective tax rate of different firms in exactly the same way. In the short-run, firms may attempt to shift income between accounting periods to reduce their tax liability (Scholes and Wolfson, 1992). In the long-run, firms are likely to modify their investment and financing positions in order to exploit any incentives in a new statute. Long-run action might include increasing the level of debt, exercising options to purchase leased assets, exploiting any provision provided or exercising clauses in existing contracts that allow renegotiations.

Firms that are listed on the stock exchange would also tend to respond to the changes that take place related to the particular industry. Positive shocks, such as encouraging news on tax law changes, would induce stock price of listed firms to move on a better note as compared to a negative announcement.

This market behavior is consistent with the standard finance theories that suggest that the rate of return on an asset is determined by systematic economic news while no extra reward can be earned for diversifiable risk.



In this thesis, the listed firms on the Malaysian Stock Exchange under the hotels sector are analyzed to determine the impact on effective tax changes on firms and its respond by the securities market. By observing the earning management of the firms, its hoped to provide estimates as to the influence on stock prices on fundamental information on tax announcements.

The following section provides a summary of the major changes in Malaysian tax law over the period analyzed and discusses the related literature.

### **Industry Information**

1990 was declared by the Malaysian government as the Visit Malaysia Year, thereby providing a high profile for Malaysia in the international tourism market as well as the leisure industry in the country.

By the end of 1990, earning from tourism grew by 60.5% to reach RM 4.5 billion as compared to 1989 (Malaysian Tourism Board Report 1994). With such considerable increase in receipts, tourism in 1990 stood as the 3<sup>rd</sup> major foreign exchange earner after manufacturing and crude petroleum.

Based on the Warton Economics Forecasting Action Group, findings in 1995, the tourism and leisure industry will generate 24% of the Worlds gross output at a

value of US \$804 billion and by the turn of the century this figure will increase by over 29% compared to 1990.

Such rapid growth has brought about the growth of the leisure industry as well as the growth in other related sectors of the industry, such as the variety chains of hotels, motels, resorts, theme parks, golf courses and many more.

A continuous growth in Malaysian GDP, approximately 9% over a period of more than 5 years had brought to an increase in the average disposable income and time of the people in this country. This resulted with the demand for leisure to become increasingly important and desirable. Along with this the demand for leisure facilities (Malaysian Tourism Board Report 1997) has also attributed to the increase in the tourist trade.

Such a positive move provided a net positive balance of about RM 1 billion in the 1996 Malaysian current account balance of the tourism industry. This revenue is expected to grow further in the 7<sup>th</sup> Malaysian Economic Plan. Such as interest allocation for the development and improvement of infrastructure, increased private investment in tourism through the provision of incentives to develop tourist and leisure attractions and encourage better incentives for hotels, motels and resorts.

The development of recreational and leisure facilities has ranged from public parks, holiday resorts with leisure entertainment sites, water parks, golf courses and all other exciting activities which provide fun and pleasure for all ranges of ages, society and backgrounds.

The idea of pleasure, joy and fun could be linked back to the concept of leisure spelt by De Grazia (Sebastian 1961) which defines it as “the state of being free of everyday necessities”. So the evident that leisure is, “it’s the notion of free choice of an individual”. As to the level of participation it would generally depend on what social, logical and political conditions that are likely to result in an individual’s freedom (Coalter 1989).

In the context of Malaysia, urbanization has brought about new modes of leisure activities in response to new life styles; and such situations has further led to the growth of formal leisure service organization, whose primary function is to provide leisure services to the general population. The development of hotels, resorts and entertainment parks, has created a healthy revenue generating avenue, for entrepreneurs venturing into this industry.

This progressive development saw the generation of revenue increased tremendously, to a 60% hike in the total revenue generated from all leisure related activities in the year 1990 as compared to 1982.

**Table 1            Tourist Arrivals and Receipts 1982 - 1997**

<b>Year</b>	<b>Tourist Arrival (Million)</b>	<b>Growth %</b>	<b>Total Revenue (Million)</b>	<b>Growth %</b>
1982	2.774	+9.5	1,132	-
1983	2.926	+5.5	1,329	+17.5
1984	2.947	+0.7	1,426	+7.3
1985	3.109	+5.5	1,543	+8.2
1986	3.217	+3.5	1,669	+8.2
1987	3.358	+4.4	1,795	+7.5
1988	3.632	+7.9	2,012	+12.1
1989	4.846	+33.7	2,803	+39.3
1990	7.445	+53.6	4,500	+60.5
1991	5.847	-21.5	2,283	-4.8
1992	6.016	+2.9	4,595	+7.3
1993	6.503	+8.1	5,066	+10.2
1994	7.197	+10.7	8,298	+63.8
1995	7.468	+3.8	9,175	+10.6
1996	7.138	-4.4	10,354	+12.6
1997	6.210	-13.0	9,699	-6.3

Source Lembaga Penggalakan Perlancongan Malaysia, 1997

A total of 4,500 million Malaysian Ringgit of revenue was generated from the leisure industry in 1990. The tourist arrival figures also show a similar increase of almost 60% rise when compared to 1982, with a total of 7,445,908 tourists arriving in Malaysia. Malaysia Hotel Supply Statistic, (1997).

Since the declaration of Visit Malaysia Year 1990, international and local hotel chains have ventured into the industry. Lately, due to increased demand, various golf courses also took the same step in providing golfing experience as part of leisure activity. The most recent phenomena emerging in the leisure industry are the theme parks that provide great pleasure of fun and thrills for the younger generation.

Now lies the question as to what length will this growth be able to sustain. Based on the element of risk of the industry, its view from the past is that the higher the risk, the greater are its returns. However with regular government tax law changes, managerial decision has to be made timely and accurately to capitalize any short-term gains and avoid any downfalls.

One of the most significant external change that each and every industry is forced to face is the frequent tax requirement and provision change and introduction of various new incentives to boost the industry. New tax provisions were also implemented for the leisure industry mainly the hotel sector. Various tax incentives were introduced, such as Investment Tax Allowance and Pioneer Status in early 1990 for a period of 5 years.

However, the effectiveness of these incentives need further valuation, since the financial results of these firms saw immediate decline in its profits during the post-incentive period.

**Table 2 : Financial Results for Financial Year 1997 and 1998 (RM 000')**

Hotels	Financial Year 1997		Financial Year 1998	
	Turnover	Profit after tax	Turnover	Profit after tax
Grand Central	45,456	8,379	28,829	(9,312)
Faber Group	245,110	90,761	414,786	(320,136)
Landmarks Bhd.	249,095	(39,833)	198,096	(66,343)
Saujana Cons.	84,291	(101)	50,011	1,928
Shangri-La Bhd.	257,710	33,791	238,584	14,378

Source : Annual Financial Statements Reports, 1997 and 1998

## **Tax Reform**

Tax provisions have traditionally been used by governments to guide private firms and individuals either towards or away from a particular investments and activities, Shah and Toye (1978).

Among some of the countries that relied heavily upon tax incentives to promote growth and development into the 80's are Bolivia, Brazil, Columbia, Ghana, Indonesia, Liberia, Jamaica, Malaysia, Pakistan, Singapore, Venezuela, and Turkey (Shah and Toye, 1978).

From past experience, at least four strategies that can be used in subsidizing investment through granting the investment incentives :

- a) subsidize all new firms or all new investments,
- b) limit subsidies to all firms within a well defined set of industries,
- c) subsidize firms which meet a set of criteria, and
- d) restrict subsidies to firms that would not invest without a subsidy

Despite the pervasive use of tax incentives, there has been a few attempts to evaluate the effectiveness of these incentives. The evidence of the effectiveness of incentives on investments in developing countries remain unclear. Shah and Toye (1978) conclude that “their impact is either slight or unknown” and the persistence of their use is influenced by political economy.

Timing for adoption of tax regulatory changes can be simultaneous either through phase by phase or sequential. Tax system must change to accommodate fundamental changes in economic and political environment of developing countries, World Bank (Box 4.7, 1988).

### **Malaysian Taxation in Transaction**

The last two and half decades have brought significant changes to the Malaysian economy. From a largely agrarian economy, it is now transformed into a rapidly industrializing economy that has successfully pursued growth with distributional objectives. Its economy grew rapidly in the seventies as a result of buoyant commodity prices and favourable external conditions. The rapid growth provided the country with the resources necessary for its ambitious socio-economic development programs aimed at eradicating poverty and restructuring society. Public development programs as well as nonfinancial public enterprises grew rapidly during the seventies.

At the start of the eighties, the government adopted counter-cyclical programs as to the prolonged world recession. These programs boosted the economy in the short-term but soon resulted in growing deficits on the government budget and the current account of the balance of payments. The government acted quickly to deal with the situation, since 1984 it adopted wide ranging adjustment measures that

had a profound effect on the direction of fiscal policy and the economic management of the country.

The measures include consolidation of the public sector, arresting the rapid expansion of the public enterprise, relaxing certain guidelines and legislative measures that constrained public enterprise and providing liberal investment incentives to the investors.

These policy measures, coupled with improved external conditions, helped the economy to turn around in 1987 and made rapid recovery. Since then the Malaysian economy has consistently registered growth rates above 8 % per annum.

As part of the efforts to re-orientate Malaysia's development strategies, in the mid 1980s, the government took steps to improve the tax system to stimulate private sector investment and economic growth.

By 1986, several tax reforms were underway. The corporate income tax was reduced in stages to stimulate investment and keep abreast with the tax regimes of neighboring countries. The investment incentives and tax allowance of various sectors were expanded, with the adoption of the Promotion of Investment Act. 1986.



## **Tax Incentives**

In the 1990 National Budget, the government in line with "Visit Malaysia Year" to encourage the growth of the tourism industry, introduced various incentives for the tourism related industry. Firms incorporated in Malaysia were offered two types of incentives such as the Pioneer Status and the Investment Tax Allowance.

The Investment Tax Allowance is more suited to capital intensive industries or projects with long gestation periods. It is an alternative to pioneer status which is more of a profit oriented incentive.

Companies with pioneer status can surrender their pioneer status and apply for investment tax allowance or apply at the end of their tax relief period or apply in respect of a promoted activity or promoted products.

### **Pioneer Status**

Based on the 1990 budget speech, which was addressed on the 22<sup>nd</sup> October 1990 in Parliament House, granted pioneer status to all companies that either fall under the manufacturing, agricultural, hotel, tourist or other commercial sectors which participate in a promoted activity or produces a promoted product. The manner in which the incentives are available depends on the date of such an application.